October 31, 1991

COORDINATED ISSUE
GROUND TRANSPORTATION INDUSTRY
SIDE TRACK DEPOSITS

ISSUE

May funds advanced by a shipper to a railroad for construction of a spur track be omitted from income? Under what circumstances are investment credit and depreciation allowable to a railroad for track constructed with such funds? How should a railroad account for repayment of deposits? How should a railroad account for deposits never repaid? Is a change from recognizing deposits as loans to recognizing them as advance payments for services a change in method of accounting for purposes of IRC 481?

FACTS

Railroad companies will construct spur lines at the request of a shipper. The shipper is required to make a deposit with the railroad prior to the start of construction. The deposit is equal to the estimated cost of constructing the spur line. The shipper and the railroad will enter into an agreement whereby the railroad will refund the deposit to the shipper. This refund is generally based on a certain dollar amount per car moved over the spur line. In most cases, under this method, the deposit is returned in full to the shipper after five or ten years.

The railroad typically does not record the deposit received as income, but it will sometimes claim both investment credit and applicable depreciation at the time construction is completed. As an alternative, the railroad will follow the decision rendered in The Denver & Rio Grande Western Railroad Company, 74-2, USTC Par. 9827, claiming investment credit and depreciation only to theextent deposits are repaid under their agreement.

A typical agreement for construction of a side track may contain the following provisions:

(A) The shipper at its sole expense and in a manner satisfactory to the railroad, shall construct or arrange construction of that portion of the side track from its facilities to the right-of-way of the railroad.

(B) The railroad, at the shipper's expense, will furnish labor and material and construct that portion of the side track from the right-of-way line to join the main track.

(C) The shipper will deposit with the railroad a sum of money (side track deposit) representing the estimated cost to build the side track on the railroad's property. If the actual cost of work covered by the deposit is more than the estimate, the shipper agrees to pay the additional cost promptly upon presentation of a bill by the railroad; however, if actual cost of work covered by the deposit is less than the amount deposited, the shipper will be refunded the difference upon completion of the work and determination of the actual cost by the railroad.

(D) Railroad will refund to the shipper a specified amount of money per car on all cars where system mainline haul revenue handled by the railroad equals or exceeds a specified amount per car up to a maximum of the actual cost of constructing side track on railroad's property. Such refunds shall be made for a period of years, normally five, from the date said work is completed and the side track is certified by the railroad as being ready for service, or until the shipper has received refunds the total equal to the actual cost, whichever comes first.

(E) If the refunds are not completed within the specified period of time, the entire unrefunded balance, if any, shall be forfeited to the railroad and said portion of track shall continue to be owned by the railroad.

LAW AND ARGUMENT

Whether side track deposits are income is a factual determination depending on the restrictions involved, whether the deposit is actually a non-shareholder contribution to capital or whether it is payment for services rendered.

The passage of time marked by several lines of court decisions indicates that the concept of income has emerged from a very narrow interpretation (per the old Cuba Railway and Liberty Light series of cases) to a very broad interpretation (per Teleservice Company of Wyoming Valley type of case). Accordingly, viewing the nature of most side track contracts, a conclusion would be reached that restrictions placed on the railroads are so marginal that the funds they receive are virtually held without restriction. It follows from this, and it can be credibly argued, that the payments are for services rendered.

In other words, what is really happening is not a gift inspired by charitable or public service motives, but a payment intended to obtain the services that a railroad is in the business of providing. A payment can't be considered a contribution to capital when it is extracted from a customer as preliminary requirement to doing business with him.

The principal issue to be decided then, concerns how payment by a shipper to a railroad should be characterized. If this payment constitutes a loan, no income is realized at the time of receipt. U.S. v. Ivey, 414 F2d 199 (5th Cir. 1969). However, if the amount paid is treated as an advance payment for services, the full amount is includible in the railroad's gross income in the year of receipt.

Under the advance payment characterization, a shipper would be considered to have made a prepayment for transportation services that the railroad would include in income when received. A payment received in advance by a taxpayer, without restriction as to its use for services to be subsequently furnished, is taxable income in the year received. (Schlude v. Comm., 372 U.S. 128 1963).

In the Denver & Rio Grande Western Railroad Company v. U.S., 505 F2d 1266 (Ct. C1. 1974), the Court of Claims considered whether a spur line built with funds advanced by a shipper qualified for depreciation and investment tax credit. A mining company advanced funds to a railroad for the purpose of building a spur line so that the company could transport its ore more efficiently. The railroad agreed to refund a specific percentage of the revenue accruing on all car load freight traffic using the spur line for a period not to exceed 10 years until the funds advanced to it were refunded. The company would forfeit any amounts not refunded by the end of the 10-year period.

The Government argued that the railroad was not entitled to the investment credit or depreciation deductions for the line on the grounds that since the railroad had paid nothing for the line, and had no binding obligation to pay a definite amount for the line, it had a zero basis in the line. The Court of Claims agreed with the Government's characterization of the amounts received as a loan and contingent liability observing that the funds refunded to the company were based on the shipper's use of the spur line with a provision that after 10 years the shipper would forfeit amounts not repaid. Accordingly, the Court adopted a compromise position holding that for purposes of the investment credit and depreciation deduction, the railroad could include the advances in its cost basis, but only gradually to the extent that the advances were actually refunded. It should be noted that in the Denver & Rio Grande case the Government did not argue that the advanced funds constituted an advance payment for services, nor does the opinion indicate that the Court considered this classification of the transaction.

The tax consequence for repayment of side track deposits to the shipper obviously ties to the determination of whether the amounts received are income when received or constitute loans and contingent liability. If the deposits are income when received, then it would follow the repayments are deductible when paid.

The question regarding forfeited amounts retained by the railroad also ties to the determination of whether the deposits are prepayments for services and income or contingent liability. If the deposits are income when received, the forfeiture would appear not to result in tax consequence.

Depreciation deductions and investment credit would appear appropriate for the year the spur tracks are placed in service if deposits are included in income when received. The Court of Claims in the Denver & Rio Grande decision limited depreciation and investment credit to the railroad's basis, which the court determined included advances only to the extent refunded to the shipper.

If deposits are advance payments for services and included in income when received, is this a change in accounting method initiated by the Government? IRS is not changing the timing of income from cash to accrual or from deferred to current recognition, but is maintaining that what was accounted for as a contingent liability is prepayment of services and therefore income when received.

POSITION TAKEN BY TAXPAYER

The Association of American Railroads states the deposits in question are not income because they are received by the railroad subject to two primary restrictions. That is, they must be used to construct track and they must be paid back, the railroad profiting only in the event the anticipated traffic does not materialize (resulting in forfeiture of a portion of the deposit). Neither party to the contracts in question intends at the outset that the deposits shall be income to the railroad. See Growers Credit Corporation, 33 TC 981.

The Service relies on Teleservice Company of Wyoming Valley, 27 TC 722 to assert the taxability of side track deposits. Such case is distinguishable from our situation. In Teleservice the contributions were obviously intended as payment for services to be rendered, and there was no repayment obligation. Further, in Teleservice the company credited deposits to its surplus. The railroad industry credits them to a liability account.

Historically, the Commissioner has not attempted to tax side track deposits, except those forfeited under terms of the contracts, and then only in the year they became non-refundable. This is evident since only at that point can the amount be reasonably determined.

The cited cases relating to prepayment for services to be rendered are not applicable herein because the side track deposits are not applied against bills of lading or other charges for services rendered by the railroad in any event. Denver & R.G.W.R.R. v. United States, 505 F2d 1266 (Ct. C1. 1974) does not consider the prepaid income issue. The funds were received by the railroad, credited to a liability account, and refunded to the shipper based upon car originations on or destinations to said side track at an agreed upon rate. The railroad did not receive, hold, or apply the funds to freight revenues.

It is the position of the railroad that the deposit of funds by a shipper pursuant to the terms of the side track agreement created a valid creditor-debtor loan arrangement between shipper and railroad. The railroad's obligation to refund the deposit to shipper was fixed throughout the five-year period; only the rate at which repayment was to be made was uncertain. The fixed obligation was terminated in either of two ways: (1) the payment by the railroad of refunds equal in amount to the deposit, or (2) the expiration of the five-year period, whichever may first occur.

Amounts never refunded to the shipper and forfeited to the railroad were properly credited against basis. See <u>Denver & R.G.W.R.R. Co.,</u> 32 T.C. 43 (1959), <u>aff'd on other grounds</u> 279 F2d 368 (10th Cir. 1960).

The holding in <u>Denver & R.G.W.R.R. Co. v. United States,</u> 505 F2d 1266 (Ct. C1. 1974)is in error insofar as it purports to rely upon the holding in the earlier <u>Denver & Rio Grande</u> Tax Court case, <u>supra.</u> The issue in the Tax Court case was whether the railroad's basis for purposes of determining gain or loss on disposition should be reduced by industry deposits which were not refunded to the shipper within the requisite period. The case does not purport to determine whether the railroad's initial basis for depreciation should be reduced by the amount of the industry deposit. Further, the Court of Claims case does not consider the basic question of whether the deposit was income when received. It can certainly be argued that if the deposit is not income
when received, a liability sufficiently definite to preclude income realization must therefore exit.

If it is determined that the side track deposits are includible in income when received, then it is the position of the taxpayer that the resulting audit changes by the Internal Revenue Service constitute a change in the method of accounting as defined by Reg. Sec. 1.446-(e)(ii)(a). As such the adjustments required by the changes in the method of accounting set forth in Section 481 are properly allocable.

Accordingly, the railroads propose the following:

1. Deposits are not to be considered income when received due to the obligation to repay.

2. Forfeitures are to be considered income when forfeited.

3. Investment credit and depreciation is to be allowed when a spur is place in service. (This follows from the fact a basis in the property is created by the contractual obligation to repay.)

POSITION TAKEN BY THE SERVICE

The AAR proposal to the effect that a basis is created by a railroad's obligation to repay deposits received does not logically fit into the concept that is stated in Revenue Ruling 50-555, as follows:

> "The Service will continue to follow the rule to the effect that a taxpayer receiving contributions in aid of construction may not claim a basis for the assets in which such amounts are invested, for purposes of depreciation or otherwise, to the extent that the amounts received were not included in income..."

But this issue is larger than the question of contributions in aid of construction. It deals with the receipt of funds that are tendered byshippers for the purpose of assuring themselves access to movement of freight by rail -- the heart of a railroad's daily business activity.

The payments, by whatever name they are called, are income to the receiving railroad for reasons stated in preceding sections of this document. Income is to be given a broad interpretation. Restrictions on the use of funds are to be interpreted narrowly.

We will hold the following:

1. Deposits, unless clearly shown to be encumbered by very restrictive provisions, will be considered income when received.

2. Repayments will be deductible as made, under proper accounting rules.

3. Investment credit and appropriate depreciation are allowable when the side tracks are placed in service.

4. In no event will investment credit and depreciation be permitted without a corresponding match of either income or railroad investment out of its own resources.